The past two years have been challenging for investors. A large number of employees saw their 401(k) accounts diminish, often times to levels that made it necessary to delay retirement. It is always easy to look back and say: “If I had just ... moved all my money to cash before the market dropped; not had all my money in stocks; not bet on this one company that was a sure deal ..., etc.” We are all susceptible to fear and greed, the two emotions that drive so many investors’ decisions. We will outline below five major mistakes which, if avoided, could help you build a portfolio that may better weather future financial storms.

1. Not paying attention to proper asset allocation can get an investor into trouble very quickly. After 2008 and the failure of a diversified portfolio to protect from the downward moves of the broad markets, there was a lot of discussion on the merits of asset allocation. It is not as important to know how much risk you are willing to take than it is to find out how much risk you have to take in order to reach your financial goals. Asset allocation begins with determining how much of your portfolio should be in fixed income (cash and bonds) versus equities.

Once this is determined, the next step is to construct a portfolio that utilizes asset classes with a low correlation (correlation is a measure of how closely two asset classes move together in both up and down markets). If there is a low correlation, the two asset classes together are designed to reduce volatility in the portfolio; if they have a high correlation, they will not.

Figure 1 illustrates how 2008 was an outlier year (the correlation of asset classes to the S&P 500 was very high in 2008 when compared to the longer-term correlation going back 10 years). We still believe asset allocation with low-correlating asset classes is the most effective approach to potentially decreasing future volatility and maximizing potential gains of a portfolio over the long term.

2. Failure to rebalance. Once an investor’s asset allocation is determined, that investor must pay attention to the original percentages allocated to each asset class. This does not only relate to the allocation between fixed income and equities, but also to the allocation within the equity portion, such as having a predetermined allocation between large, medium, and small companies, domestic and international, as well as growth and value style managers. If investors had paid attention to this rule in the 1990s when tech stocks led the bull market, they would have periodically reduced their holdings in this category, thereby taking profits along the way. Then they would not have been caught in the “tech bubble” and had 80% or 90% of their portfolios exposed to the downturn, as was often the case.
Avoiding these five investment mistakes may help to keep you on track and positioned to reach your financial goals.

3. Timing the markets. In our opinion, attempting to time the markets is a pitfall for investors. Figure 2 clearly illustrates the effects that being out of the market at the wrong time can have on your portfolio.

Staying the course and not jumping ship is sometimes easier said than done, especially after a year like 2008 when there was no place to hide from the downturn, with the exception of cash and government securities. If we step back, however, and use history as a guide, we see markets have proved quite resilient and have shown the ability to snap back after deep losses. Figure 3 illustrates the oil crisis of the 1970s and how, at the bottom of the market in October 1974, investors who pulled investments out of the market experienced a 44% loss from the beginning of the downturn. Those who stayed the course recovered in one year and eight months with a one-year return of 44.46% from the bottom.

It is just as important not to make large bets on stocks and not to fully reallocate a portfolio into the stock market when you feel that the upward momentum is in full swing and you fear that you would be missing out on potential gains. These types of market-timing decisions can often prove detrimental as the momentum will undoubtedly slow and turn at some point, leaving the portfolio more vulnerable to losses.

4. Chasing returns. This is another mistake that many investors make when choosing a money manager. It’s been said that “there is a season for every investment, but not an investment for every season.” Each sector, each asset class, each management style has its own cycle. One cannot predict when a cycle is at its top or at its bottom. Therefore, using past performance of a manager or an asset class as the only criterion for investment decisions can again lead to being “whip-sawed.” Many times investors jump into a particu-
Investor Experience

Oil Crisis (1972–1976)

Market Bottom: October 3, 1974

Did nothing
Bought more ($100,000 additional investment)
Sold out

Recovered in 1 year, 8 months
Recovered in 5 months
Realized 44% loss

+44.46%

Source: Alliance Capital. Past performance is no guarantee of future results.

Figure 3 illustrates clearly that asset classes perform in cycles, which makes following one’s original asset allocation plans and rebalancing even more important.

5. Failure to monitor.

Determining the appropriate asset allocation based on your resources and goals and constructing an efficient portfolio is only the beginning of the investment process. Equally important is the process of updating goals and resources at least annually to continually test the appropriateness of the asset allocation, and then making necessary adjustments to the current asset allocation so it closely matches the asset allocation goal.

Avoiding these five investment mistakes may help to keep you on track and positioned to reach your financial goals.